TESTIMONY

OF ANDREW J. JETTER

PRESIDENT AND CHIEF EXECUTIVE OFFICER

FEDERAL HOME LOAN BANK OF TOPEKA, KANSAS

BEFORE

THE FEDERAL HOUSING FINANCE BOARD

February 10, 2004

Chairman Korsmo, members of the board, my name is Andy Jetter, and I am the president and chief executive officer of the Federal Home Loan Bank of Topeka.

Thank you for the opportunity to testify today at this hearing on corporate governance. I strongly support the Finance Board's focus on this important and timely topic. Although I have vetted my testimony with members of my board of directors, the statements I make today, and the positions I espouse, are mine and are not intended to be a statement of any official position of the Topeka Bank or its Board of Directors.

In general, I believe the corporate governance practices at the Topeka Bank are very strong. We welcomed the Finance Board's horizontal review of our governance practices and we subsequently embraced many of the "best practice" recommendations made in the final report. However, there is one area that I believe needs further evaluation: the director election and appointment process. While we continue to evaluate and implement improvements in corporate governance practices that we exercise some control over, we recognize that changes in the election and appointment process for directors can only be made by Congress, with respect to statutory provisions, and by the Finance Board, with respect to regulatory provisions and appointment practices.

Before addressing my recommendations on improving the director election and appointment process, I want to comment generally on the broader question of the best approach to evaluating and developing recommendations for improvements in the corporate governance practices at the Federal Home Loan Banks. It may be more fruitful for the Federal Home Loan Banks to create a task force composed of directors and management that would undertake a comprehensive study of governance practices. Such a group would need adequate time to complete its work and provide a formal report of its conclusions. Its report would be informative for the Finance Board in evaluating its regulations and practices, for Members of Congress as they evaluate possible statutory changes affecting corporate governance, and for the Federal Home Loan Banks themselves as we each strive to improve our own governance practices. I intend to explore this proposal with the other Federal Home Loan Banks to determine the level of interest in proceeding with such an endeavor.

Underpinning the recommendations I will make today is the belief that the governance practices at the Federal Home Loan Banks should mirror the best practices employed in public corporations generally, subject only to such modifications that are necessary and appropriate because of the unique structure of the Federal Home Loan Banks. Adoption of these practices should be strongly encouraged.

I'd like to address three areas with respect to the selection of directors: (1) the director appointment process; (2) the director election process; and (3) my recommendations for how these processes can be improved. But before I do that, let's discuss briefly the overall objective in selecting particular individuals to serve on a board. Regardless of whether we are appointing or electing directors, the basic objective is the same. It is critical that members of a board of directors possess the appropriate skills, education and experience to perform their duties. I am not suggesting that every director must possess identical skills, education and experience, as it is vitally important to have diverse interests and backgrounds represented on a board of directors of a Federal Home Loan Bank. However, Federal Home Loan Banks are large, complex business organizations that require a combination of directors that jointly have the knowledge to understand the bank, both in terms of its operations as well as the management of the risks those operations create. It is imperative that a Federal Home Loan Bank's board be composed of both elected and appointed directors that can understand and provide meaningful oversight of the operations of that Federal Home Loan Bank.

With respect to the current appointment process, I see several weaknesses that need to be addressed. I acknowledge that there does seem to be an objective to promote diversity in terms of the individuals appointed, which I wholeheartedly endorse as essential to good corporate governance. However, more emphasis should be placed on how the specific experience and skill sets of a potential director would complement those that already exist on the Federal Home Loan Bank's board.

The appointed directors with whom I am familiar are individuals of good character and successful in their chosen careers, and bring value to the deliberations of the board. And each is individually qualified to serve as a director. However, I have not sensed that significant focus is given to identifying individuals with specific skill sets needed on the board to complement the skill sets of our other directors. Clearly, good corporate governance practices strongly suggest that the objective is to build a board of individuals that have a variety of skills, but that collectively possess all of the skills necessary to provide effective oversight of the Bank.

I find especially troubling the apparent policy against reappointment of current directors, although I understand some exceptions are being granted for individuals originally appointed to fill less than a full three-year term. In an organization as complex as a Federal Home Loan Bank, this bias against reappointments results in a loss of experience and knowledge gained through prior service as a director. Both the selection process for appointed directors and the barriers to reappointment should be reconsidered.

An even more significant concern with the current appointment process is a problem that can only be fully remedied by Congress. I appreciate the Finance Board's endorsement of the importance of being an independent regulator and observing a bright red line between the regulator and the regulated institution. But the current situation in which the regulator appoints directors to the board of the regulated institution is completely inconsistent with this concept. The selection of directors by the Finance Board represents a clear violation of the independence objective and creates an unhealthy situation where the regulator has a major role in the management of the regulated institution. The ultimate resolution of this issue is to amend the Federal Home Loan Bank Act to remove Finance Board responsibility for the appointment of directors of a Federal Home Loan Bank. An alternative sometimes suggested but which would be just as inappropriate would be to have the President of the United States make these appointments directly as is done with the other housing GSEs. An interesting development, according to recent news reports, is that the President has decided to not reappoint directors to Freddie Mac's board when the existing terms of appointed directors expire, apparently to eliminate a similar conflict. Bottom line, the United States Government should not be in the business of appointing directors to non-governmental corporations, even if those corporations are government-sponsored enterprises.

Appointed directors provide significant strength to the overall governance of a Federal Home Loan Bank. I am not suggesting in any way the elimination of directors completely independent of management and member stockholders. But the selection of those directors should be done in a manner similar to public corporations where they are nominated by boards of directors and then stand for election by stockholders. This process would retain the vital role these directors play while ending the inherent conflicts in the current appointment process.

Now let's turn to the process of electing directors. It is clear that the current voting rules set forth in the Federal Home Loan Bank Act have the effect of increasing the control of smaller member stockholders in the voting process relative to larger members who own a majority of the outstanding shares of a Federal Home Loan Bank's stock. These provisions significantly reduce the likelihood of representatives of major stockholders serving as directors of the Federal Home Loan Bank, thus depriving its board of directors of the unique expertise such individuals often possess. Don't misunderstand what I'm saying: executives of smaller member institutions are fully qualified to serve as directors of the Federal Home Loan Bank and not having any directors representing this major constituency would be a mistake. With that being said, additional consideration should be given as part of the election process to the identification of the specific skills, experience and education needed in order to build the most qualified board of directors possible.

Currently, the Finance Board prohibits by regulation the involvement of the board of directors and the management of a Federal Home Loan Bank in the election process. That regulation, 12 C.F.R. 915.9, reads in part:

> No director, or officer, attorney, employee, or agent of [a Federal Home Loan] Bank may: . . .
>
> communicate in any manner that a director, officer, attorney, employee, or agent of the … Bank, directly or indirectly, supports

> the nomination or election of a particular individual for an elective office; or <u>take any other action to influence votes for a directorship</u>.

The effect of this regulation is to prevent the board of directors of a Federal Home Loan Bank from fulfilling its proper role in seeking the election of individuals whose particular skill sets would best complement those of other directors and does not reflect current thinking on best corporate governance practices.

Finally, let me provide specific recommendations on how to improve the director election and appointment process. With respect to both appointed and elected director positions, current directors and management need to be actively involved in the selection process. Boards and management should work cooperatively to identify needed skill sets that will enhance the performance of the board, identify individuals that possess such skill sets and then recommend those individuals for appointment or election.

At first glance, the recommendation to include management in the process seems to fly in the face of current trends in corporate governance that focus on ensuring that there is independent oversight of corporations sufficient to prevent the problems associated with entrenched management. The ultimate responsibility for an organization lies with its board of directors. How then, can giving management, along with boards, a larger role in the selection of directors be consistent with good governance practices?

To understand why this position is consistent with best corporate governance practices, one must recognize where governance practices have been and where they are headed. The problem that exists in large corporations with thousands of shareholders is that management can indeed become entrenched. By nominating for open board positions only those individuals with close ties to the CEO, a board of individuals loyal to the CEO is formed. The most effective approach to reduce or eliminate this risk is to require that a majority of the directors serving on the board be independent of management and to encourage independent directors to take a greater role in the nomination process. In other words, on the continuum of corporate governance practices with one end at which practical control and influence lies completely with the CEO and the other at which practical control and influence lies completely with directors independent of management, current governance recommendations suggest that corporations need to move away from complete CEO dominance such that outside directors are given significant responsibility and influence.

But I am not aware of any best practice recommendation that would support moving to the other end of the continuum where outside directors have complete control and the CEO has little or no influence. In the case of director selection, completely excluding management from the selection process is simply not representative of best corporate governance practices. The challenge we have in applying best corporate governance practices to a Federal Home Loan Bank is that Federal Home Loan Bank boards have no management representation. However, virtually all research on governance practices assumes that management is, at a minimum, represented on the board and typically the CEO of the organization also serves as the chairman of the board.

Let me be clear, I am not suggesting that management should serve on the board of directors. However, management should actively assist the board in the identification of individuals to recommend for election and appointment as directors.

In conclusion, the Finance Board has the ability to immediately and significantly enhance the corporate governance practices of the Federal Home Loan Banks by taking the following steps:

1. Rescind 12 C.F.R. 915.9 that prohibits the involvement of boards and management in the election of directors and encourage boards and management to become actively involved in identifying qualified individuals to serve as directors and recommending the election of those individuals to the Federal Home Loan Bank's stockholders.
2. With respect to appointed directors, place the responsibility on each Bank's board of directors, with management assistance, for determining the desired skills needed on the board and for identifying individuals who possess those skill sets. Provided that the recommended individuals meet appropriate guidelines, the Finance Board should appoint those individuals as directors. In essence, the Finance Board would be devolving this critical corporate governance function to the boards of directors where it more properly belongs. We believe that the Administration, given its recent position on the appointment of directors for Freddie Mac, would support this change in practice.

3. Support legislation that would devolve to the stockholders the authority to select independent directors.

These changes will place responsibility for the governance of a Federal Home Loan Bank where it properly belongs -- with the board of directors and stockholders of that Bank.

However, if the Finance Board chooses to not adopt these recommendations, I urge that it at least consider the following changes:

- Make the appointment process more open so that the selection process is fully understood;
- Solicit input from the Federal Home Loan Bank boards and management on the particular skill sets that would be beneficial in appointed directors;
- End the bias against the reappointment of directors; and
- Complete the appointment process no later than December 31st each year.

In summary, my recommendations can be boiled down to a few sentences. The process of selecting qualified directors is a critical component of good corporate governance. Best corporate governance practices clearly place that responsibility with an organization's board of directors and management. The Finance Board should take appropriate steps to permit the Federal Home Loan Banks to implement that best practice.

Thank you for the opportunity to address this important topic. I'd be pleased to answer any questions you may have.